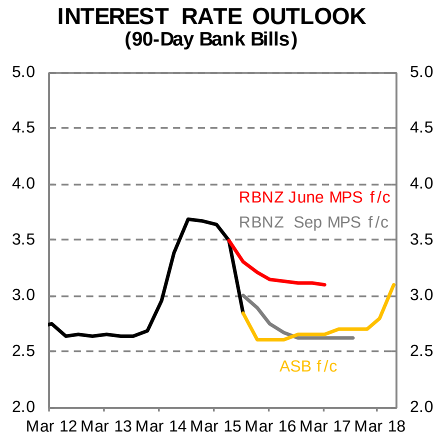
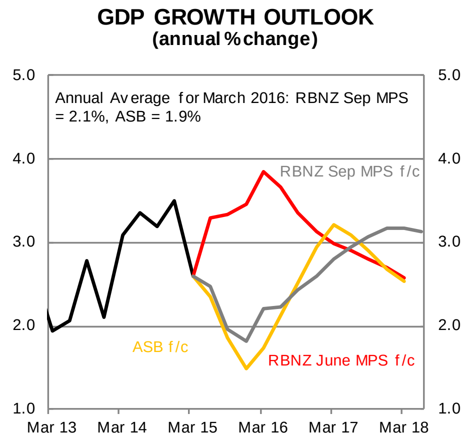
Economic Update

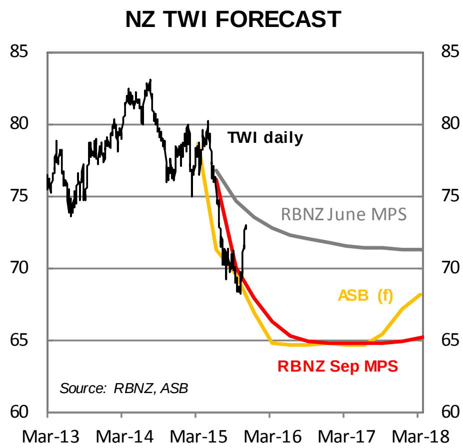
October OCR Preview 22 October 2015

Shoulda Coulda Woulda

- **We now expect the RBNZ will remain on hold in October, and cut the OCR 25bp in December.**
- **The RBNZ appears comfortable to wait, though we believe an immediate cut would be more prudent.**
- **We are also sceptical that inflation will be as strong as the RBNZ currently expects over 2016 and 2017.**







Summary

The RBNZ's September Monetary Policy Statement made a further OCR cut contingent on "the emerging flow of data". For the October OCR decision, we judge **the RBNZ will be encouraged enough by recent events to keep the OCR on hold**, in favour of cutting in December. In particular, dairy prices have rebounded and the Q3 inflation outcome was in line with the RBNZ's expectations. Nevertheless, we think the RBNZ *should* cut the OCR in October, and that it is a tighter call than the 20% chance market pricing suggests. **An October OCR cut isn't totally out of the question** – particularly if the RBNZ is unhappy about the NZD's rise and doesn't want to add to it.

We are wary of the risks that inflation is more subdued over 2016 and 2017 than the RBNZ anticipates. Underlying pricing pressures are very muted. The NZD has also rebounded. W**e are also very mindful the RBNZ could be overestimating how stimulatory interest rates are** for the economy.

October decision: 'coulda' but probably won't

An October OCR cut has been dependent on events**. The RBNZ Governor's speech on October 14 gave a pretty strong hint that events have been upbeat enough to remain on hold for now**:

- Recent data have been "encouraging";
- The RBNZ wants headroom to cut rates if the global economy slows significantly.
- House price increases were a concern from a financial stability point of view and the RBNZ is required to have due regard for monetary policy's impact on financial stability;

The main positive development relative to the RBNZ's outlook is the sharp rebound in dairy prices. Business and consumer confidence have found a floor. Furthermore, **the RBNZ suddenly appears more nervous about the spreading strength of the housing market**, despite previously distancing monetary policy from housing's financial stability concerns.

Based on the speech, **all the above developments appear to outweigh the events suggesting some reduction in inflation pressures**:

- The marked lift in the NZ dollar, currently 7% higher on a trade-weighted basis than the average the RBNZ assumed for Q4;
- Downward revisions to global growth;
- Q2 GDP slightly underwhelming the RBNZ's forecast;
- Very weak pricing results in the Quarterly Survey of Business Opinion.

The case for 'shoulda' cut

We acknowledge that the RBNZ is likely to be comfortable leaving the OCR on hold in October. Nevertheless, for a number of reasons we think the RBNZ 'should' cut the OCR in October.

A significant reason for cutting sooner rather than later is the rebound in the NZD. **The RBNZ's medium-term inflation outlook is heavily dependent on tradable inflation rebounding** and sustaining a pace at/above 2.5% until 2018, while non-tradable inflation remains subdued. **The NZD's rebound will see inflation languish below 1% for longer**, and further delay a return of headline inflation to the 2% medium-term anchor.

The NZD has been lifting because: markets are pushing out expectations of when the US Federal Reserve will lift interest

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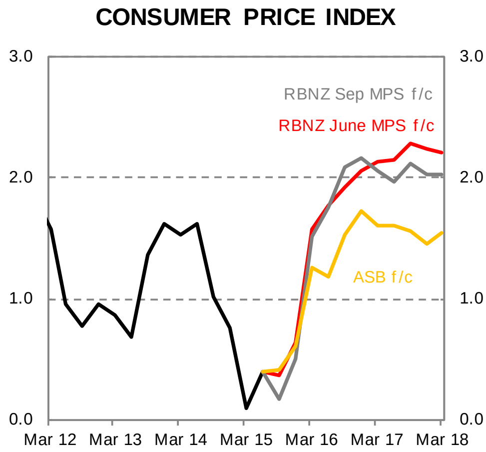
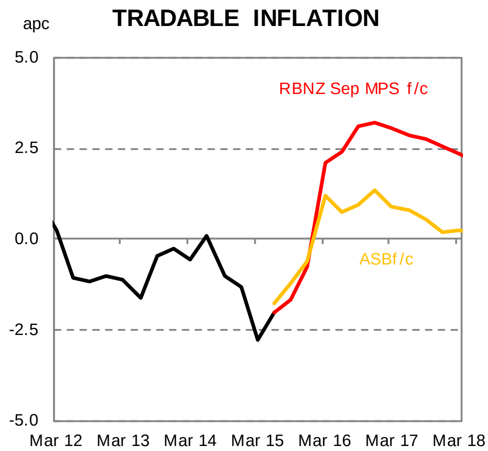
rates; dairy prices are rebounding, and; markets are pushing out expectations of when the RBNZ will next cut the OCR.

The RBNZ appears to be pinning a lot of hope on the US Federal Reserve pulling the NZD/USD down. But, its own actions matter. If it chooses to keep the OCR on hold it can hardly complain if markets were to start doubting whether the RBNZ will cut again at all and push the NZD up even further.

On top of the NZD lift are several other reasons we think argue for cutting now:

- The lift in dairy prices is a positive, but it has been in part triggered by a drop in milk production. **All up we see recent dairy developments as a net drag on GDP** – any added farmer spending will be more than offset by the lost production and downstream activity;
- The **underlying trend in non-tradable inflation**, of 0.2/0.3% per quarter **is low**, yet economic growth is past its peak and slowing;
- And finally, as we detail below, over the longer term **we are very wary that inflation will not lift to the extent the RBNZ currently expects**.





Longer-term inflation outlook: a little deflated

In our considered view, the risks are inflation will struggle over the medium term to hold around 2%. Our own inflation forecasts, at a 2.5% OCR setting, do not reach 2% at any point over the next few years. Some key reasons we believe there is scope to drop the OCR below 2.5% are:

- **The risks that tradable inflation is not as persistently strong over the next few years as the RBNZ assumes**, in part on the NZD impact previously discussed but also a muted global inflation environment;
- **The risk of wage pressure remaining subdued** unless migration slows sharply soon: we expect an unemployment rate near 7% as opposed to the RBNZ's forecast peak of around 6.1%, with migration boosting labour supply;
- **House price concerns are best left to macro-prudential policy**, rather than holding broader economic growth hostage to those concerns;
- **The RBNZ's estimate of the neutral[1] interest rate risks being too high**, a point we expand on below.

Neutral OCR: RBNZ assumption looks too high

Recent research from the RBNZ implies a 'neutral' OCR setting is 4-4.25%, but we think this is too high. This research is based off a variety of estimation techniques of this unobservable concept. There is a large degree of uncertainty among the wide range of estimates. A few of these models suggested the neutral 90-day rate was closer to 3.8% (implying around a 3.5% OCR) - which seemed more plausible to us.

To us, it just does not seem like monetary policy is very stimulatory right now. The extent of stimulus (or restriction) is judged relative to the assumption of neutral. So, another perspective to consider is how the economy is responding to the current level of interest rates. The RBNZ's 4-4.25% assumption suggests the current 2.75% OCR is 125-150bp into stimulatory territory. However, we have an economy that is struggling to grow above 2-3%, with a large degree of slack remaining and unemployment struggling to fall convincingly. Credit growth is positive, but not impressive. **It is worth remembering that since the OCR first reached 2.5% in April 2009 it has only been above 2.5% for 28 months out of 77. And the OCR was last at 4% 7 years ago.**

From a risk perspective, deflation is far more dangerous and damaging that inflation being modestly too high. Cutting the OCR might run the risk of inflation flirting with 3% rather than 0.3%. Monetary policy is all about making decisions in the face of uncertainty, based off what is expected to influence future inflation outcomes. **Inflation could well turn out to do just what the RBNZ currently expects – we just have our doubts.**

If inflation remains subdued there is an opportunity cost of foregone growth. To us making monetary policy decisions off a view the neutral interest rate is 4+% feels a bit like lending your car to Thelma and Louise: it may come back washed and waxed – but there is a nagging doubt things may not turn out as well as you'd hope.

[1] The neutral interest rate concept is best thought of as the interest rate that will neither accelerate nor decelerate economic growth and will keep inflation stable at the inflation target – the Goldilocks interest rate.

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